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Response to FRC Consultation Paper on Auditor Liability Limitation Agreements

The City of London Law Society (CLLS) represents over 13,000 City lawyers, through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response to the FRC Consultation Paper on Auditor Liability Limitation Agreements has been prepared by the CLLS Company Law Sub-Committee. This Sub-Committee is made up of solicitors who are expert in their field.

Question 1: Does the draft guidance meet the objectives summarised in paragraph 8?

We think the draft guidance fails to meet the objectives in three important respects:

- we think that the factors to be considered when assessing the case for an agreement should be expanded and clarified, as explained in our response to Question 3;

- we think the discussion of what matters should be covered in an agreement (Section 4) and the specimen clauses need substantial revision. In particular, the draft does not adequately explain what is intended to be achieved through the "Proportionality" limitations. We think that Section 4 would be much more useful to companies and their shareholders considering whether to accept a liability limitation agreement if it discussed the implications of the different approaches in more detail. There is some discussion in the Commentary on the specimen clauses but we feel the issues of principle should be addressed within the body of the guidance. We have a number of material comments on the specimen clauses.

- we note that the specimen clauses apply the limitation of liability to "breach of trust" by the auditor. We are not convinced that there should be any limitation of liability

for breach of trust and it would be helpful if the guidance could set out the reasons why liability should be limited.

The problems of proportionality

We are particularly concerned about liability limitation agreements where the proportionality approach is adopted. We do not think the effect of a limitation based on "proportionate" liability is well understood and the effort to define what it means in detail (as in the specimen clauses in Appendix B(i)) gives rise to complex and difficult questions. Given these we see considerable merit in a simpler approach in which the liability is limited to what is "fair and reasonable" (Appendix B(ii)).

We believe that the principal difficulty, which is apparent from the cases where the courts have addressed the issue, arises from the nature of the auditor's function, which includes identifying deficiencies in the way a company accounts for its transactions. The auditor is never the primary cause of those deficiencies but the auditor may be liable for negligent failure to identify them. Any assessment of proportionate responsibility will therefore involve an allocation of responsibility between those who have directly caused the loss and those (the auditors) who have failed to protect the company from that loss.

Given the complexity of the issues, if the more detailed approach to proportional limitations is retained, it requires a rather more detailed discussion than currently appears in the guidance.

Contributory negligence

This issue has been addressed in the courts where the liability of the auditor has been reduced as a result of contributory negligence. It is clear that there is a degree of management failure that will be regarded as sufficient to require a reduction in the amount of damages the negligent auditor may be required to pay. We perceive that one of the purposes of a proportionate liability limitation agreement would be to confirm that this principle should apply. We do not think this should be regarded as controversial but it would be helpful if this was explained in the guidance.

Non-fraudulent third parties

The application of the proportionality principle as it appears in the specimen clauses in Appendix B(i), other than in relation to contributory negligence is more problematic.

The specimen clauses take the concept of proportionality much further than simply contributory negligence. The basis of allocation of liability in paragraph C(i) of version 1 is according to:

- liability for;

- causation of;

- contribution to,

the loss or damage suffered by the company.

The parties whose involvement in the loss may be relevant include:

(i) directors and employees of the company who have acted negligently;

(ii) third parties engaged by the company, such as valuers and lawyers;

(iii) third parties (other than employees and other individuals for whom no-one is vicariously liable) who have been fraudulent in their dealings with the company;

(iv) third parties, such as regulators, who have caused or contributed to the loss but who, for policy reasons or otherwise, have no liability for their actions.

The guidance would be much more useful to companies and their investors if it considered the implications of a “proportionality” approach in relation to each of these.

We discuss the allocation of liability between auditor and fraudster under “Fraud" below. For the reasons we give there a majority of the working party responsible for this response think that allocation should be solely on the basis of the “fair and reasonable” approach.

We also question whether it is right to include employees and directors (category (i)) or third parties with no liability to the Company (category (iv)) in the assessment of the auditor’s liability. Perhaps the easiest way to illustrate the issues that arise with this approach is to consider some examples:

(i) *a company has a proper system of payment controls in place but a director or employee acts negligently in approving payments and as a result a continuing fraud is successfully perpetuated against the company; the auditor negligently fails to identify the fraud or the failure to operate the payment controls effectively*:

In this case, how does the principle of proportionality intend the liability to be allocated? Leaving aside the issues relating to the fraudster (dealt with below) the loss is caused by the director or employee and (to the extent it continues after the negligent audit) by the auditor but the way the auditor causes the loss is qualitatively different, as the failure is to protect the company from the negligence of the director/employees (and the fraud) that has occurred. We question whether negligent failure by a director or employee should be taken into account other than in the "contributory negligence" sense dealt with in paragraph C(iii). An allocation based on causation, as between negligent director/employee and auditor is likely to be balanced in favour of the auditor as the director/employee will be seen as the direct cause of the loss, while the auditor’s contribution to cause is indirect. The courts' approach to contributory negligence takes into account the special nature of the auditor's duty and may well produce a different result from that which would arise from allocation of liability based on causation. In the example given, it is likely that the auditor

would say that the negligence of the director/employee is the direct cause of the loss and therefore the auditor should take only a small proportion of the liability. If that is the intended effect, we think the guidance should make that clear;

(ii) *the accounts include valuations of fixed assets based on valuations provided by independent valuers; the valuations, which overstate the values of the assets, were carried out negligently by the valuer and the auditor was negligent in not identifying the issue*:

In this case, the effect of "proportionality" is relatively simple as it simply ensures that the allocation of responsibility that might be reached in a claim for contribution under the Civil Liability (Contribution) Act 1978 defines the limit of the liability of the auditor. The company (not the auditor) selects the valuer and it is not unreasonable for the company to assume the risk of non-recovery against that party;

(iii) *the company, which is a regulated business, incurs significant losses as a result of the fraudulent activities of an employee; the auditors negligently fail to detect the fraud. The regulator is also negligent in failing to identify weaknesses in the systems and controls of the company. However, the regulator is not liable to the company for its failure.*

We think many companies and their shareholders would be very surprised at the suggestion that auditors should “share" liability with a regulator who has no liability, even if the regulator has caused (in a "but for" sense) or contributed to the loss. We suggest the Working Party should reconsider whether it is appropriate to take into account parties who have contributed to causing a loss but who have no liability to the company. If this approach is retained, the guidance should make it very clear that this is the effect and set out the reasons why it should be regarded as reasonable. We would differentiate the case of third parties who are not liable by virtue of an agreement with the company. It is reasonable to leave the company to accept that part of the liability that would otherwise have fallen on such a third party but we do not see that as a justification for a sharing of liability between the auditor and those who as a matter of law have no liability to the company.

Fraud

The approach to losses caused by fraud requires separate consideration. The approach in Version 1 of the proportionality clauses differentiates between:

(i) fraudulent employees;

(ii) fraudulent natural persons for whom no-one is vicariously responsible;

(iii) fraudulent third parties (other than natural persons for whom no-one is vicariously responsible), (this appears to be optional but there is no explanation of whether it should be included).

In relation to fraudulent employees and individuals for whom no-one is vicariously liable, the amount of the auditors' liability is limited to an amount that is fair and reasonable. We agree

with this approach, and (to some extent) with the explanation given in the commentary:

"it could be regarded as unreasonable to reduce the Auditor's Liability applying the test in C(i) above because it would probably leave the Company with only a very limited recovery against the Auditor and little prospect of recovering against the fraudulent employee".

We do not, however, understand the reason for the distinction between these two categories of fraudster and a person for whom another person is vicariously responsible (or a fraud perpetrated by a company). The distinction seems to be made on the basis of an assumed likelihood of recoverability rather than of principle. A majority of the working party responsible for this response think all cases of fraud should be dealt with in the same way. We do not see how it is possible to allocate responsibility according to causation when one party (the fraudster) is clearly wholly responsible and the primary cause of the loss. In that case, is the auditor to escape any liability? If the effect of the proposed clause is to require the court to consider how it would allocate liability in a hypothetical contribution claim between auditor and fraudster, we think it will only be in exceptional cases that the court would think it just and equitable to make the auditor (who owes no duty to protect the fraudster from his liability as such) bear any of the liability. This seems to be the thinking behind the comment quoted above and we agree that the result is unreasonable.

In cases of fraud, the limitation is to the amount that is "fair and reasonable" and in addition to the statutory factors (s537, Companies Act 2006) certain other factors are to be taken into account. We accept that it may be useful to set out two of the factors ((a) (opportunities for the auditor to discover the fraud) and (b) (opportunities for the company to discover the fraud)) but the third ((c) (contributory fault)) is dealt with in the contributory negligence limitation (paragraph C(iii)).

It follows from our comments on Version 1 of the proportionality specimen clause that we do not think Version 2 is appropriate.

Our suggestion

If the simple “fair and reasonable” approach to proportionality is not to be adopted a majority of the working party responsible for this response suggest the following as an alternative:

- as between auditor and other persons (other than the directors and employees of the company and fraudsters) who are liable to the company for the loss, the auditors liability should be limited to a “just and equitable” allocation based on causation

- as between auditor and fraudster the limitation should be based on what is “fair and reasonable”

- the contribution of directors and employees to the loss should be taken into account only on the basis of the contributory negligence of the company.

Question 2: Should the final guidance identify which methods of setting the auditor's liability are most likely to be acceptable in particular circumstances as proposed in paragraph 10, or simply set out the options as in the draft guidance?

We agree with the approach in the draft guidance of setting out the options. We think that it is preferable for bodies representing specific interest groups (such as the ABI and NAPF) to publish their own recommendations. This will provide greater flexibility for the thinking of those groups on these issues to evolve as experience develops of how liability limitation agreements operate in practice.

Question 3: Does Section 3 of the draft guidance identify all of the main factors to be considered when assessing the case for an agreement? If not, what other factors should be considered?

We think the following comment in paragraph 3.2:

"The existence of a liability limitation would not reduce or otherwise affect the legal and professional obligations imposed on auditors in respect of the quality of the audit."

is too simplistic.

While we agree that in its terms this is a true statement, it could be taken as suggesting that the acceptance of a liability limitation agreement will not affect the standards applied by the auditor in performing the audit. That may be the case but is not necessarily so. Has the FRC undertaken any work to support this contention? Companies may legitimately ask whether agreeing a liability limitation agreement might prejudice the quality of the audit and they may want to discuss this with the auditor proposing the limitation. It would be helpful if the guidance suggested that such a discussion may be appropriate. We suggest in any event that the paragraph might be rephrased as follows:

“Auditors are subject to professional standards they are required to follow and to a duty to act with reasonable care and diligence in performing their functions and these requirements will not be affected by an agreement that limits their liability.”

We agree with the statement in paragraph 3.4.

For the reasons given in response to Question 5, we think that the guidance should be more helpful in trying to identify the practical implications of liability limitation agreements.

The first reason given in paragraph 3.5 amounts in reality to two different reasons depending on whether the limitation is proportionate or of a fixed amount and it would be helpful if the guidance could make this distinction:

- A proportionate limitation is designed to allocate liability according to responsibility (although as explained in our answer to Question 5 we think the simplicity of the

proposition disguises a considerable complexity and uncertainty of meaning of "proportionate").

- A fixed limit is designed to match liability to available resources; it does not allocate liability according to responsibility.

In addition, this first reason is expressed as a statement of an objective without explaining why that is a proper objective for directors to take into account. We agree that directors can legitimately take into account a general policy objective (for the good of the commercial community as a whole) but to do so they must accept the validity of the policy. In order for directors to do that it would be helpful if the guidance could explain the basis for this policy objective and set out some of the reasoning that would justify it.

Although some boards may have doubts about the general policy objective as a basis for agreeing a liability limitation agreement, we think that the second stated reason on its own will usually be sufficient (however unattractive it may be to companies) for directors to conclude that the liability limitation agreement is in the best interests of their company. This is the reason we would expect to see advanced by directors in the explanatory circular when approval of a liability limitation agreement is sought.

An additional factor that might usefully be mentioned in paragraph 3.6 is that companies often agree limitations of liability in their agreements with service providers (not least auditors providing non-audit services). The reasoning that justifies limitations in those contexts may be equally applicable to the decision to accept an auditors liability limitation agreement.

We suggest the first and third points made in paragraph 3.9 would be better included within paragraph 3.6 as these are factors to be taken into account in deciding whether a liability limitation agreement should be entered into. It would be more helpful if the third point in paragraph 3.9 could be developed further to spell out how the relationship between directors/management and outsider shareholders might affect the decision to adopt a liability limitation agreement. If this suggestion is accepted, the remaining point in paragraph 3.9 could be added at the end of what is currently paragraph 3.10.

Question 4: The guidance is intended to be equally applicable to public and private companies. Are there different considerations for private companies, and does the guidance address them adequately?

We see the principal differences between public and private companies as likely to be:

- it may be that shareholders in owner-managed companies attach less importance to the audit, in which case a lower financial limit may be more appropriate, particularly if it leads to lower audit costs;

- private companies will more easily be able to engage in an interactive discussion with shareholders which will allow the advantages and disadvantages of agreeing to the limitations to be explored in more detail.

Question 5: Are there any other procedural issues that should be covered in Sections 4 and 5 of the guidance?

Our comments on the procedural issues in Sections 4 and 5 are as follows:

- paragraph 4.6 suggests that limits other than on the amount of liability (such as time limits) may also be relevant. We do not think it is clear that such limitations are capable of being approved by shareholders. Such limits are within the prohibition in s 532 (as a provision "exempting" an auditor from liability) but it is not obvious that a time limit is a limit on the "amount" of liability for the purposes of s 534.

- it would be helpful to point out in the guidance that a liability limitation agreement may apply to an audit that has been completed.

- we agree that, as suggested in paragraph 5.14, listed companies are likely to seek to have a liability limitation agreement approved at the AGM falling in the year to which it relates. It would be helpful if the guidance could emphasise more strongly the importance of company and auditors reaching agreement on what is to be proposed relatively early in the financial year. It might be helpful to suggest that auditors wishing to propose a liability limitation agreement should do so well in advance of that time.

- it may be helpful to point out that where a liability limitation agreement is presented for approval at the AGM at which the re-appointment of the auditors is also proposed it will be necessary to explain to shareholders, if it be the case, that the auditors have indicated that they are not prepared to accept the appointment if the liability limitation agreement is not approved by shareholders. In these circumstances the auditors for the then current financial year would fall to be appointed by the board and if the new auditor insisted on a liability limitation agreement that would have to be approved at a general meeting. Companies should be encouraged to explain the likely consequences of shareholders not approving the liability limitation agreement in the explanatory circular by which approval is sought.

- in paragraph 5.19, we think it would be helpful to point out that if approval of the agreement is obtained as set out in paragraph 5.14, there will be no opportunity to withdraw the authorisation.

- the discussion of limitations applicable to groups (paragraphs 4.7 and 5.5 to 5.18) would be more helpful if it dealt in more detail with the difficulties that may arise. The approach in the specimen clauses, of leaving it to the companies in a group to reach agreement on how the limitation is to be allocated, presents real problems if all or some of the companies in the group are insolvent or leave the group (we note the suggestion that companies may want a fallback mechanism but no guidance is given on what kind of mechanism would be appropriate).

Question 6: Do you have any comments on the specimen principal terms, clauses and resolutions and notices in Appendices B to D?

We attach in the Appendix our suggested amendments to the specimen clauses in Appendix B (i), reflecting the approach we have advocated in our comments above.

20 March 2008

Appendix

Suggested amendments to the Specimen Clauses (Appendix B(i) Principal Terms: Proportionality (Version 1))

A: This Agreement limits the amount of any liability owed to the Company by the Auditor in respect of any negligence, default[, or] breach of duty[, or breach of trust][1], occurring in the course of the audit of the accounts for the financial year [beginning/ending] [insert date] pursuant to [this Letter of Engagement or the Letter of Engagement entered into on [date]] of which the Auditor may be guilty in relation to the Company ("The Auditor's Liability").

B: This Agreement shall not limit the amount of any liability of the Auditor for fraud [consider whether to include any other carveouts] or any other liability that cannot be excluded or restricted by applicable laws or regulations.

C: The Auditor's Liability shall be limited in accordance with the following sub-paragraphs:-

(i) where any Person (as defined below) other than (a) a director or an employee of the Company [2]or (b) a Deliberate Wrongdoer (as defined in sub-paragraph C(ii) below)) is also liable to the Company [3]for all or part of the same loss or damage as the Auditor or would have been so liable but for an agreement with the Company[4], (a Responsible Person), the Auditor's Liability shall be limited to such amount as is [5]just and equitable having regard to the extent to which the Auditor and any other such Responsible Person has caused or contributed to such loss or damage. Any limitation, exclusion or restriction (however arising) on the liability of any other such Responsible Person and any other matter (whenever arising), including inability to pay or insolvency, affecting the

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[1] We have questioned whether it is appropriate to limit liability for breach of trust.

[2] Directors and employees are excluded on the basis that the Company's responsibility for its officers and employees is dealt with as contributory negligence under C(iii).

[3] As noted in our comments, we do not think the limitation should be on the basis of causation absent liability

[4] We think it is right that contractual liability exclusions should be ignored for these purposes.

[5] We are not convinced that it is appropriate for an agreement to provide for a matter to be referred to a court (or an arbitrator) in this way. As an alternative to simply deleting this drafting you might replace the deleted text with "Neither the Auditor or the Company shall assert that a determination of the Auditor's Liability may not be made on the evidence before the court notwithstanding that a Responsible Person is not a party to the proceedings, whether as a party to the proceedings or as a witness."

possibility of recovering compensation from any other such Responsible Person shall be ignored in determining:-

(1) whether and to what extent that Responsible Person is liable to the Company;

(2) the extent to which the Responsible Person caused or contributed to the loss and/or damage suffered by the Company; and

(3) the amount to which the Auditor's Liability should be limited.

[6]In any proceedings in which a Court is required to determine whether and if so to what extent the Auditor's Liability should be limited, neither the Auditor nor the Company shall unreasonably resist the joinder to the proceedings or the calling as a witness in the proceedings of such other Responsible Person.

"Person" means any corporate body, individual or other person, which expression shall for the avoidance of doubt include any company, any director or employee of the Company, persons associated with the Company, persons providing or who have provided finance or services to the Company including other professionals, and any governmental or regulatory authority or body.

(ii) where any Person is also liable to the Company for all or part of the same loss or damage as the Auditor by reason of fraud or dishonesty ("a Deliberate Wrongdoer") [and that person does not or does not appear able to satisfy any Order or Judgment against them][7], the Auditor's Liability shall [8]be reduced by such amount as is fair and reasonable in all the circumstances of the case having regard in particular to the matters referred to in sub-section (1) of section 537 of the Companies Act 2006 and without regard to any of the matters referred to in sub-section (3) of the said section 537, and in addition having regard to the following matters:-

(a) the opportunities reasonably available to the Auditor to discover the fraud or dishonesty of the Deliberate Wrongdoer; and

(b) the opportunities reasonably available to the Company to discover such fraud or dishonesty;

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[6] We do not think the parties can by agreement determine whether the Court has sufficient evidence to make a determination.

[7] We think that these words should be deleted. That avoids the potentially difficult assessment called for by the proposed drafting and ensures that the auditor's liability is reduced to what is fair and reasonable, without jeopardising the auditor's right to bring a contribution claim against the fraudster if there are assets to satisfy the claim.

[8] We have sought to deal with cases where more than one sub-paragraph is relevant in a new sub-paragraph (iv).

(iii) where any loss or damage suffered by the Company as a result of the Auditor's breach of duty has been caused or contributed to by any fault on the part of the Company, its directors or employees other than a Deliberate Wrongdoer the Auditor's Liability shall be further reduced by such amount as is just and equitable having regard to:-

a. those matters stated to be taken into account and/or to be disregarded under section 537 of the Companies Act 2006;

b. the relative fault of the Auditor and the Company and its said directors and/or employees;

c. the extent to which the loss and damage complained of was caused by such fault on the part of the Auditor and the Company (and those for whom it is responsible) respectively.

(iv) if sub-paragraphs C(i) and C (iii) are both relevant to a determination of the amount of the Auditor's Liability those sub-paragraphs shall both be applied together and if sub-paragraph C(ii) is relevant to a determination of the amount of the Auditor's Liability in addition to either or both of sub-paragraphs C(i) and C (iii), those sub-paragraphs shall be applied first.